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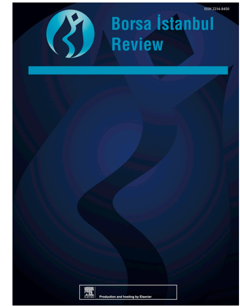

Risk, Capital and Financial Crisis: Evidence for GCC Banks

Saibal Ghosh, PhD

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Risk, Capital and Financial Crisis: Evidence for GCC Banks

Abstract
Employing data on over 100 GCC banks for 1996-2011, we test the relation between risk and capital. Given the interlinkage between these two variables, the model employs a 3SLS estimation that takes on board this simultaneity. Consistent with the literature, risk is measured by the Z-score, while capital is computed as the ratio of equity to asset. The findings indicate that banks generally increase capital in response to an increase in risk, and not *vice versa*. Second, there is an uneven impact of regulatory pressure and market discipline on banks attitude towards risk and capital. Additionally, Islamic banks increased their capital as compared to conventional banks. Besides, the evidence testifies to the fact that banks with higher dependence on wholesale funds and less diversified income profile have higher risk.

JEL classification: G21, G28

Key words: Z-score, capital, 2SLS, banking, GCC

1. Introduction

The relationship between bank capital and risk-taking is one of the key issues in the banking literature. The minimum capital standards advocated by the Basel Committee which are sought to be implemented are premised on the rationale that increased capital enhances bank safety. However, this premise might often turn out to be less than relevant. By way of example, increased capital might induce a bank to assume greater risks. If this effect outweighs the buffer effect of capital, highly capitalized bank might experience a higher probability of failure. Such risk-taking behavior explains why otherwise well-capitalised banks often experience significant declines in their capital position. An offshoot of this relationship is that capital regulation alone might not be sufficient to ensure the soundness of the banking system.

Given the significance of these results, it is not surprising that several researchers have attempted to dissect the relationship between risk-taking and capitalization of banks. This literature focuses on the well-known moral hazard problems in banking. Merton (1977) shows that, given banks limited liability, they might be inclined to decrease their capital and increase risk. Other studies however, demonstrate that the relationship is not necessarily negative if factors other than the option value are considered (Kim and Santomero, 1988; Besanko and Kantas, 1996; Hellmann et al., 2000).

Akin to theoretical studies, empirical studies on this issue also do not appear to have a consensus view. On the one hand, several researchers (Furlong, 1988; Keeley, 1990; Boyd and Graham, 1996) uncover a negative relationship between risk and capitalization, others (Peek and

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